and Order, MM Docket No. 92-264, 8 FCC Rcd. 8656 (1993), at ¶62.

Thus, in addition to the same kinds of efficiencies and cost savings identified by telco commenters, the Commission must consider the effect of its cable affiliate transaction rule on cable programming and diversity, to which Congress accorded special importance, and the recognized public interest benefits of vertical integration. If the Commission revised its cable affiliate transaction rule as proposed, the burden and cost of valuing affiliated programming would increase dramatically. See Crandall Report at 13 ("Estimation of programmers' costs and fair market values would be difficult, resulting in substantial compliance costs for cable systems, cable networks, and the Commission."). Further, non-controlling investments by multiple cable operators, enabling the spreading of these admittedly high-risk investments, would be discouraged. Most importantly, by eviscerating the "prevailing price" test and requiring cable operators to sell affiliated programming at the programmer's net cost, the Commission will limit the rate of return for successful services, thereby creating a significant disincentive to vertical integration:

> In light of the high probability that a project will fail and hence lose money, it is the hope of producing a hit, and earning a substantial profit from it, that drives the development of new cable programming services in spite of these risks. One would expect license fees for such services to exceed accounting costs. The application of cost-of-service regulation will curtail substantially the profitability and hence incentive to develop new services that

> would increase diversity. There would be fewer new services, and they would be of lower quality. Cost-of-service regulation would also reduce the incentive to make investments to improve existing services.

Crandall Report at 7. The resulting loss of investment and decrease in the quantity, quality, and diversity of new program offerings far outweigh any conceivable benefit from the Commission's proposal.

V. Any Productivity Offset Would Be Particularly Inappropriate For Programming Costs.

The Commission also has proposed "to adopt a 2 percent productivity offset as part of the benchmark for regulated cable rates." Report and Order at ¶320. The Commission bases such offset on its expectation that "cable operators should reasonably be expected to achieve productivity gains in the future" as a result of "advances in telecommunications technology." Id. at ¶319.

According to the Commission, the only "evidence" in the record for such offset was submitted by the New Jersey Board of Regulatory Commissioners ("New Jersey"). Report and Order at ¶320. However, in its comments, New Jersey simply stated that "we would reduce the index by a static productivity offset, such as 2%." New Jersey Comments in MM Docket No. 92-266, filed on Jan. 27, 1993, at 16 (emphasis added). Thus, New Jersey provided no empirical support for a 2 percent productivity offset and simply offered 2 percent as an example of such offset.

In any event, the New Jersey estimate was based upon prior levels of cable operator investment in plant and equipment and research. It is unlikely that cable operators can or will maintain such levels of investment after the Commission's latest round of mandated rate reductions and the high cost of continuing regulatory implementation and compliance efforts.[11] Thus, Liberty Media respectfully submits that it would be premature and inappropriate for the Commission to impose any productivity offset until the effects of its rate regulations can be measured and evaluated.

There can be no question that the Commission properly concluded that programming costs should be excluded from any productivity offset:

> We do not, however, wish indirectly to restrict the ability of cable programmers to obtain fair value for their products. As a result, we tentatively conclude that programming costs should not be included within the productivity offset for cable system technological and operational improvement.

Report and Order at ¶322. Such exclusion is the only rational result in view of the Congressional directive to "avoid unnecessary constraints" on programming and the Commission's prior

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[11] Indeed, the Commission's rate regulation rules have forced cable operators to curtail "their equipment purchases and upgrade goals." See R. Shaw, "Rate Rules Put Squeeze on Upgrades," Electronic Media, May 30, 1994, at 18. For example, Tele-Communications, Inc. and Time Warner Cable have announced plans to reduce their capital expenditures by $500 million and $100 million, respectively. See D. Mermigas, "Time Warner Cable Details Cutbacks," Electronic Media, May 9, 1994, at 3. In addition, KBLCOM Inc. will scale back plans for "multimillion dollar rebuilds" of its systems in San Antonio, Texas and Orange County, California. See L. Haugsted, "KBLCOM: Re-Reg Slammed Brakes on Upgrade Plans," Multichannel News, May 16, 1994, at 72.

recognition that "programming costs have increased at a rate far exceeding the rate of inflation." First Report and Order, MM Docket No. 92-266, 8 FCC Rcd. 5631 (1993), at ¶8, 251. There is no basis for any "reasonable expectation" that programmers, whose costs are largely for talent and intellectual property, will experience significant efficiencies and cost savings from technological innovation.

Conclusion

Liberty Media respectfully requests that the Commission terminate further consideration of its proposals to revise the cable affiliate transaction rule and to adopt a productivity offset. Both Congress and the Commission have recognized the "substantial" consumer benefits resulting from cable operator investments in programming. The Commission's proposal to treat transactions with such programming "affiliates" under its proposed telco rules -- without considering the differences in the affiliation standards and in the telco and cable industries -- will discourage such investments and sacrifice the resulting benefits to program quality, quantity and diversity. No countervailing consumer benefit will be achieved, and the substantial costs of such regulation will be borne ultimately by viewers.

Respectfully submitted,

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Economic Analysis of the Proposed Change in the Cable Television Affiliate Transaction Rule

by

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I. Introduction and Summary

In implementing the Cable Television Consumer Protection and Competition Act of 1992, the Federal Communications Commission has imposed an affiliate transaction pricing rule. This rule limits the extent to which cable systems selling regulated services can recover expenditures on programming purchased from unregulated affiliates. The rule was adopted to prevent cable systems from inflating prices paid for affiliated programming and using pass-through and cost-of-service provisions to evade rate regulation.

The Commission has now proposed to amend the affiliate transaction rule.[1] The proposal would substantially reduce the ability of cable systems to use a network's prevailing company prices, which are the prices at which substantial sales have been made in the marketplace to third parties, as the prices for affiliate transactions. The proposed rule would greatly increase use of affiliate transaction prices equal to the lower of the programmer's cost and estimated fair market value. Evidently, the Commission believes this change would reduce significantly any evasion of rate regulation.

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1 *Report and Order and Further Notice of Proposed Rulemaking*, MM Docket No. 93-215 and CS Docket No. 94-28, FCC 94-39 (1994) (*"Report and Order"*).

The proposed rule change would affect a substantial share of cable television programming. In 1990 the Commission observed that cable systems had equity interests in 13 of the top 20 national basic cable networks.[2] Waterman and Weiss have reported that at the end of 1992 cable operators had equity interests of 5 percent or more in 26 of the 46 most popular basic cable networks.[3]

An economic analysis of the benefits and costs of this proposed rule reveals that the change would be harmful to consumers. The principal bases for this conclusion are listed below and discussed in the remainder of this paper.

1. The Commission and Congress have recognized the substantial consumer benefits in the form of new cable television networks that have resulted from vertical integration between cable systems and programming services. By discouraging vertical integration, the proposed rule change would reduce the quality and increase the cost of cable programming available to American households.

2. While the affiliate transaction rules for cable television and telephone companies appear similar, there are substantial differences in the scope and application of the rules between these industries.

3. The proposed tightening of the cable television affiliate transaction pricing rule is unnecessary. Incentives to distort prevailing company prices to evade regulation are severely limited by partial ownership and by the profits that would be foregone on lost sales of unregulated cable system services and

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2 *Report*, MM Docket No. 89-600, 5 FCC Rcd 4962 (1990) ("*Report*") at ¶78.

3 David H. Waterman and Andrew A. Weiss, "Vertical Integration in Cable Television," Prepared for the American Enterprise Institute for Public Policy Research, Washington, D.C. (1993), Table 2-2.

on lost sales of programming to nonaffiliates. My analysis indicates that in the typical circumstances that would be subject to the new rule there is no incentive to inflate prices, and hence no grounds for the proposed rule, even if the rule were costless.

4. The proposal to require extensive cost-of-service and estimated-fair-market-value regulation would be very costly and unworkable. Such calculations would impose higher costs and cause greater distortions in the cable television industry than in the traditional regulated industries such as telephone service because it is very difficult to estimate costs and fair market value for programming services, and because of the riskiness of programming investments. It would be difficult to base the prices of affiliated networks on the prices of nonaffiliated networks because each network is different. Comparisons among networks would involve subjective judgments and present fertile ground for disputes.

II. Consumer Benefits from Vertical Integration in Cable Television

The Commission and others have recognized that multiple cable system operator ("MSO") investments in programming services have benefited consumers by increasing the quality and diversity of programming. The Commission recently stated:

> Congress and the Commission have both recognized that there are benefits which result from vertical integration. First, MSO investment has produced a wealth of high quality cable programming services. Many of the most popular cable programming services were initiated or sustained with the help of MSO investment. Second, vertical integration between cable operators and video programming services appears to produce efficiencies in the distribution, marketing, and purchase of programming. Third, vertical integration can reduce programming costs, which in turn may reduce subscriber fees and cable rates.

Fourth, vertical integration may in certain circumstances foster investment in more innovative and riskier video programming services.[4]

Development of a new cable programming service involves a substantial risk of large losses. Each year many new programming services are conceived. It is impossible to determine whether a new idea will succeed without extensive marketing and, ultimately, large costs of distributing it to viewers. Most new network ideas do not appeal to enough cable systems and advertisers to merit continuation and are dropped without ever reaching the television screen. Others fail after they are launched. A minority succeed, and a limited number earn high profits. The ability of programming suppliers to spread the risks of failure across many projects affects the cost, quantity, and quality of new programming.

Frequently, new cable programming services emerge solely as concepts and then seek carriage agreements and capital from cable systems. Cable systems have used investments in new networks to expand the supply of programming that they believe their subscribers might want. Cable networks have benefited from these carriage agreements and from the reduction in risk that they convey. The situation is essentially the same if an MSO or group of MSOs decides to launch a new network. Waterman and Weiss (1993, Table 2-2) report that 25 of 60 networks were launched with at least one cable system owning equity of 5 percent or more.

The Commission has explained that "Horizontal concentration and vertical integration can ... promote the introduction of new services. ... In addition to providing needed capital and a ready subscriber base for such services, cable operators can more easily share information with producers about viewer taste, reaction to programs and desire for new programs" (Report at ¶84).

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4 *Second Report and Order*, MM Docket No. 92-264, 8 FCC Rcd 8565 (1993) ("*Second Report and Order*") at ¶68.

The Commission has also observed that Congress recognized benefits of vertical integration in adopting the 1992 Cable Act:

> For example, the House Report acknowledges that vertical relationships promote program diversity and make the creation of new and innovative programming services possible. Further, the House Report suggests that vertical relationships may be an efficient way of financing new programming services and compensating cable operators for assuming some of the risk associated with the launch of new cable programming services.... (*Second Report and Order* at ¶7, citing House Report at 41.)

The Commission concluded that "on several occasions, MSO investment has enabled a programming service to remain in operation when it otherwise would have been forced to discontinue its programming." The Commission cites Turner Broadcasting System's WTBS and CNN, the Discovery Channel, Black Entertainment Television, and C-SPAN as examples (*Report* at ¶83).[5] Subsequently, the House Report on the 1992 Cable Act also cited Nickelodeon (*Second Report and Order* at ¶43).

On the same point, according to the National Telecommunications and Information Administration:

> The cable industry's $550 million investment in Turner Broadcasting [in 1986] provided a much-needed infusion of capital to the latter firm, solidifying, among other things, the financial health of WTBS and CNN, two of the three largest basic cable networks. C-SPAN, which transports viewers to the floors of both houses of Congress,

5 Regarding the Discovery Channel, see also Discovery Communications, Inc., *Opposition to Petition of Bell Atlantic for Further Reconsideration*, MM Docket No. 93-215 (1994) at 5.

would probably not exist without financial support from the cable industry.[6]

Another benefit from vertical integration, at least when there is common control, is a reduction in contracting, monitoring, and enforcement costs between downstream and upstream firms. The Commission has concluded that "Vertical integration ... can help a cable company avoid transaction costs normally incurred in acquiring programming. Such costs include time, human resources, and money expended in negotiating and enforcing program contracts" (*Report* at ¶84). Such a reduction in transactions costs reduces programming costs and lowers prices for consumers.

The proposed rule change would discourage vertical integration in the cable industry that benefits subscribers. Cable companies would be dissuaded from financing innovative new networks if their ability to recover the costs of such investments were compromised by arbitrary regulatory rules involving the costs of the resulting programming.

The proposed rule would be likely to impose substantial costs on vertically integrated cable companies that would not be borne by independent companies. If companies are unrelated, transactions between them are not subject to the affiliate transaction pricing rule. If companies are affiliated and costs and estimated fair market value must be calculated for their transactions, they are likely to bear substantial out-of-pocket compliance costs not borne by their competitors. This cost differential, of course, will discourage vertical integration that would benefit consumers.

The proposed rule would further discourage vertical integration by creating a revenue penalty for affiliated cable systems. Under cost-of-service regulation and the 11.25 percent rate of return that would potentially be imposed, an affiliated cable system would not be able to pass

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6 NTIA, *Video Program Distribution and Cable Television: Current Policy Issues and Recommendations*, Washington, D.C. (1988), p. 91. Brackets added.

through to its customers the full license fee paid for a popular affiliated service.

To appreciate the magnitude of the latter effect, one must recall that new cable programming projects face a substantial risk of failure. In light of the high probability that a project will fail and hence lose money, it is the hope of producing a hit, and earning a substantial profit from it, that drives the development of new cable programming services in spite of these risks. One would expect license fees for such services to exceed accounting costs. The application of cost-of-service regulation will curtail substantially the profitability and hence incentive to develop new services that would increase diversity. There would be fewer new services, and they would be of lower quality. Cost-of-service regulation would also reduce the incentive to make investments to improve existing services.

A cable system that was not affiliated with a programming service would not face the same constraint on its basic service prices, and hence could earn higher profits on successful programming. Thus, the proposed rule would create an artificial incentive for cable systems to avoid ownership interests of 5 percent or more in programming services. Again, this would discourage vertical integration that benefits consumers.

III. Differences in the Application of the Rules to Telcos and Cable Systems

The proposed rule change for the cable television industry and the Commission's rationale for it are essentially the same as those for the telephone industry, notwithstanding major differences between these industries and the effects of related regulatory provisions. Indeed, the justification offered by the Commission for the proposed cable rule refers to "a detailed analysis of each of these transactions methods for telephone companies" (*Report and Order* at ¶309, emphasis added), but it does not refer to a similar analysis for cable television. It is therefore important to highlight several differences in the way these rules would operate in the two industries.

First, the standard used to define affiliation is much broader in the case of cable television than in the case of telephone companies. For telephone companies the threshold is control: "'Affiliated companies' means companies that directly or indirectly ... control or are controlled by, or are under common control with, the accounting company. ... 'Control' ... means the possession directly or indirectly, of the power to direct or cause the direction of the management and policies of a company, ..." (47 CFR §32.9000). Under this control standard, one company could have a substantial minority interest in another company and yet the two companies would not be considered affiliated for the purposes of the affiliate transaction rule. By contrast, for cable television the threshold is virtually any type of ownership of 5 percent of the other company.

Second, it is common for more than one MSO to have an equity interest in a given cable programming service. Waterman and Weiss (1993, Table 2-2) report that among 26 basic cable networks in which MSOs had equity interests of 5 percent or more at the end of 1992, there were 8 networks in which two MSOs each had an equity interest of 5 percent or more, 5 additional networks in which three MSOs had such an equity interest, and one more network in which five MSOs had such an equity interest. In such cases, the cable television affiliate transaction rule lumps together MSO owners that are not affiliated with each other in determining how much of its output a cable programming service sells to affiliated companies. This assumes that MSOs that own shares in the same programming service act as though they are one company for the purposes of inflating the price of affiliated programming, something that should not be taken for granted. Common ownership by two or more independent telephone companies of their upstream suppliers is much less common, and presumably given the control standard only one would be treated as affiliated.

Third, both the cable television and telephone company affiliate transaction rules distinguish between asset transfers and provision of services. Under the cable rule, programming is treated as an asset, even though programming is an intangible that is difficult to value. By contrast, under the telephone rule, most relevant transactions are treated as involving services. As a result, for cable television, the major burdens of the proposed rule change relate to the treatment of asset transfers. By contrast, the important part of the proposed telephone company rule change relates to services. Because of this distinction, one could imagine modified versions of the proposed rules that would still greatly impact the cable industry while having little effect on the telephone industry, even if the two rules were similarly worded.

IV. An MSO Is Unlikely to Have the Incentive and Ability to Inflate Programming Prices

The Commission's proposed rule on affiliate transaction pricing is intended to prevent evasion of rate regulation by cable systems, but the Commission has presented no empirical evidence on the significance of the problem that the rules are intended to mitigate. The Commission has not demonstrated that MSOs have the incentive and ability to inflate programming prices. Even if some MSOs have the incentive and ability to inflate prices to some degree, one would also need to consider the costs imposed by the rule before concluding that the rule would improve the situation.

Absent such evidence and analysis, the Commission proposes a rationale for the rule change that is not based on a comparison of benefits and costs. The Commission suggests that it is useful to distinguish between nonregulated affiliates whose primary purpose is to serve regulated affiliates, on the one hand, and other nonregulated affiliates whose predominant purpose is to serve nonaffiliates, on the other (*Report and Order* at ¶310). It then uses this paradigm in its justification of the rule change. However, no useful conclusions regarding the incentive or the ability to inflate prices can be obtained by this artificial attempt to identify the purposes of cable networks that are affiliated with cable systems.

Any economic analysis of the incentive and ability of a cable company to inflate the prices paid for affiliate programming requires consideration of the following points. These points make clear the forces that would deter or prevent the typical cable system from inflating affiliate programming prices even without the proposed rule change.

1. Taken alone (that is, without the profits of the affiliated programming service), the profits of the cable system will be reduced by an increase in the price paid for programming. The problem for the cable system is that the resulting subscription fee increase will cause a loss of subscribers to regulated services. The magnitude of this loss depends on the elasticities of demand for basic and expanded basic service. Where basic service subscribers are lost, the cable system will lose its gross margin (the difference between price and variable cost) not only on basic but also on expanded basic, pay, mini-pay, pay-per-view and other services that would have been sold to the lost basic service subscribers. It will also lose national and local spot advertising revenue and home shopping network commissions. If the elasticity of demand for basic service is 1.5 or 2.2, as two studies have estimated,[7] an increase in the basic subscription price as a result of an increase in license fees would cause a substantial reduction in cable system profits.[8]

2. Because the profits of the cable system, taken alone, will decline as a result of an increase in the price paid for programming, it clearly will not be in the interest of a cable system that does not have a substantial equity interest in the programming service to pay an inflated license fee. In addition, if the cable system is jointly owned by one company that has an ownership interest in a programming service and another company that does not have an ownership interest in the programming service, it is not at all clear that the affiliated

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7 Robert N. Rubinovitz, "Market Power and Price Increases for Basic Cable Service Since Deregulation," 24 *Rand Journal of Economics* 1 (1993). Robert W. Crandall, "Elasticity of Demand for Cable Service and the Effect of Broadcast Signals on Cable Prices," commissioned by TCI (1990), pp. 6-7.

8 There would be a reduction in cable system profits even though the cable system is permitted a 7.5 percent markup on programming expenditures.

owner would have the ability to inflate the license fee even if it had an incentive to do so. It would not be in the interest of the nonaffiliated partner(s) to inflate the license fee.

3. Taken alone, the profits of the programming service on sales to the affiliated cable system would probably increase if the license fee were inflated.[9] However, the profits of the programming service on sales to nonaffiliated cable systems would surely decline. In order for a cable system to inflate prices on affiliate transactions, under a prevailing company pricing rule the programming service would have to raise prices to nonaffiliated systems as well. Since the programming service was previously at liberty to charge this higher price and did not do so, it follows that the increase in the price to nonaffiliates would reduce programming service profits. The price increase would cause a loss of carriage at some nonaffiliated systems, as well as a loss of subscribers at remaining nonaffiliated systems that continued carriage. The magnitude of the loss of carriage would depend on the elasticity of demand for individual programming services on the part of nonaffiliated cable systems. This elasticity is likely to be substantial, given the many alternative sources of programming available to operators that would attract subscribers. Because it would lose subscribers, the programming service would also lose national advertising revenue, which exceeds license fee revenue for the typical cable network.[10]

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9 This assumes that affiliated systems would not reduce carriage. Some affiliated systems might reduce carriage in the absence of common control, e.g., where more than one MSO is affiliated with the programming service.

10 Paul Kagan Associates, *Cable TV Programming*, Jan. 29, 1993, p. 1.

4. Because an increase in license fees would cause a loss at the cable system, and because any profits at the programming service would be attenuated by losses relating to nonaffiliated sales, on balance a typical vertically integrated cable system would be unlikely to have an incentive to inflate prices for affiliated basic programming. The absence of such an incentive is particularly obvious if the cable system is only a partial owner of the programming service, because its claim to any increase in programming service profits would be proportional to its ownership share in the programming service.

5. A number of cable programming services are affiliated with more than one MSO. Implicitly, the proposed rule is based on an assumption that multiple MSO owners would have the same incentives and would act in unison to increase license fees in an effort to evade cable regulation. However, for a number of reasons, including different ownership shares in the programming service, the incentives of the MSOs may not be the same. Also, one of the MSOs might undercut an effort to increase license fees by reducing its carriage of the affiliated network. Problems that are likely to arise in attempting to reach a concensus on the increase in the license fee and to prevent affiliates from reducing carriage would reduce the likelihood of an attempt to raise license fees to evade cable regulation.

In summary, it is unlikely that the typical vertically integrated cable system would have the incentive and ability to inflate affiliate programming prices because of the following: (i) For services in the basic tier, a cable system would lose its gross margin from sales of basic, expanded basic, pay, PPV, and other services to subscribers, as well as from advertising and home shopping, that would be lost as a result of the increase in the basic service price. (ii) The programming service would lose its gross margins on lost sales to nonaffiliated cable systems. (iii) The cable system often has only a partial ownership interest in the programming service, and hence receives only a pro-rata share of any increase in the latter's profits. (iv) If the cable system has multiple owners, and some owners are not affiliated with the programming service, the vertically integrated owner would face the problem of persuading the non-integrated owners to pay an inflated price for programming. (v) If more than one MSO has an ownership interest in the programming service, these MSOs would be likely to face problems in coordinating to evade regulation.

The proposed rule would impose cost-of-service and fair market value pricing on affiliate transactions when the cable system owns as little as 5 percent of the programming service and purchases as little as 25 percent of the latter's output. By contrast, a typical cable system would not have an incentive to raise prices for a basic network even if it owned two-thirds of the programming service and purchased two-thirds of the latter's output.

V. Problems of Cost-of-Service and Fair Market Value Regulation

The proposed rule would require cable systems to use the lower of the programmer's cost and estimated fair market value for affiliated networks in determining prices charged for regulated cable service. Estimation of programmers' costs and fair market values would be difficult, resulting in substantial compliance costs for cable systems, cable networks, and the Commission. In addition, even in situations where it would not reduce vertical integration (see Section II), the proposed rule would reduce investments by vertically integrated cable companies to develop new networks and to improve existing ones.

Numerous problems relevant to the proposed rule change for cable television were described in comments filed in the similar rulemaking for telephone companies.[11] For example, Coopers & Lybrand filed comments dated Dec. 9, 1993, stating:

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11 *Notice of Proposed Rulemaking*, CC Docket No. 93-251, FCC 93-453, 58 FR 62080 (1993).

> The FCC's goal of having objective, auditable rules, which has been accomplished up to now, would be substantially eroded with the adoption of the proposed rules. ... In summary, the Reconsideration Order[12] described very important and appropriate criteria that the Commission considered in establishing its affiliate transaction rules: objective rules that are verifiable and easy to monitor and audit. The proposed rules move away from those criteria, create a complete new layer of work to value services, make it far more difficult for companies to determine whether they are in compliance with rules, add complexity and subjectivity to the audit process and render the company and auditor conclusions subject to continued debate because the market valuation of services adds substantial subjectivity to the rules. (Footnote added)

The Commission itself recognized the many difficulties of basing prices on costs of service in connection with its evaluation of price caps for telephone companies. For example:

> The second inherent difficulty associated with administering rate of return regulation relates to its requirement that determinations be made about how to allocate a carrier's costs among services that often are provided jointly or in common. ... It must be recognized ... that even though cost allocation systems may deter anticompetitive activity and assist in its detection, these results may be obtained at a high cost to society. This is so because a cost allocation system can present a strong deterrent to anticompetitive activity and, at the same time, be so detailed and rigid that it imposes on a carrier a complex and inflexible rate structure, one that may have little relation to consumer demand. If such a rate structure is deployed in a competitive environment, it may result in distorted consumption

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12 *Order on Reconsideration*, 2 FCC Rcd 6283 (1987) ("*Order on Reconsideration*").

decisions, distorted production decisions, and distortions of the competitive process.[13]

One would expect the problems caused by cost-of-service regulation to be much greater for highly differentiated products such as cable programming services than for the more homogeneous ones relevant to telephone companies. First, cost-of-service regulation has usually been applied to activities such as local exchange carrier telephone service in which standardized physical capital with a reasonably predictable life span accounts for the majority of investments. In such industries, there is at least a chance to develop a reasonable depreciation schedule. This is important because the depreciation schedule has a major impact on cost-of-service prices. The situation is entirely different for cable television programming, where the majority of investments involve intellectual property. There is no way to predict precisely the life span of a cable television network or its program investments. As a result, it would be difficult to arrive at a sensible schedule to use in depreciating the large initial investments in program development.

To be specific, suppose that it costs $30 million to launch a network that attracts one million subscribers in its first year. How much of the $30 million should be amortized in the first year and passed through in regulated rates? Given the uncertainty about the success and life span of the network, any decision on amortization amounts to an arbitrary decision about the price that can be passed through to subscribers. If a particular network turns out to be more successful over time than the amortization rules assume, cost-of-service regulation would produce the bizarre result that the amortization per subscriber and therefore the price that cable systems would be allowed to pass through to subscribers would fall while its value to subscribers was increasing.

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13 *Report and Order and Second Further Notice of Proposed Rulemaking*, CC Docket No. 87-313, 4 FCC Rcd 2873 (1989) at ¶32.

Second, measuring the costs of producing entertainment programs is notoriously difficult. Talent may negotiate for shares of profits rather than current payments. Contracts may be front-loaded or back-loaded. There are many problems in allocating the joint and common costs of a programming service among the networks it supplies. Past efforts to determine the costs and profits of motion pictures have been highly contentious.

Third, the proposed use of cost-of-service and estimated-fair-market-value prices would reduce the profits earned by vertically integrated cable companies on successful networks. Given the limited share of programming investments that earn a profit and the substantial losses on those that do not, cable companies must earn high profits on successful projects in order to have an adequate incentive to invest. In this respect, the situation for cable television networks is much the same as it is for motion pictures, network television programs, and popular books. All of these involve high risks, because a high share of costs occur up front as development costs, because they are sold in highly competitive markets, and because there is a high probability of failure and great difficulty in predicting success in advance. Thus, one observes a wide range of profitability for individual projects, with many failures and a few very profitable projects. Consumers are the beneficiaries of this process and would be harmed by a provision that would reduce the profitability of successful projects. The situation is quite different for local exchange carrier telephone services, because they are not yet subject to the same degree of competition that faces cable networks and their investments in plant are much less risky.

It should be added that when cost-of-service regulation is applied to different industries, the allowable rate of return should reflect the risk of the relevant investments. Thus, cable television programming would require a relatively high rate of return, and even this would not mitigate many of the problems of cost-of-service regulation.

Fourth, the proposed rule would give cable systems a perverse incentive to replace more popular, successful affiliated programming, for which they would be unable to pass through the full license fee to subscribers, with less successful programming on which they could recover their costs.

Finally, fair market value is not a practical standard for pricing cable television programming services. It would be difficult to base the prices of affiliated networks on the prices of nonaffiliated networks because each network is different. Comparisons among networks would involve subjective judgments and present fertile ground for disputes.

Indeed, in the case of telephone service, the Commission specifically rejected use of fair market value: "Several parties have argued that if a tariff or prevailing price is unavailable as a measure of value, we should look to the value of similar services in the marketplace. We believe that such a valuation standard is fraught with the potential for abuse, and would be difficult to monitor" (*Order on Reconsideration* at ¶131).

The Commission addressed the difficulties of using prices that independent suppliers charge in certain contexts, and it is not at all clear why these same comments would not apply to the use of such prices in a fair market value calculation for cable programming.

> Except to the extent that they are relevant for estimating fair market value, we will not allow the establishment of affiliate prices by reference to the prices independent suppliers charge third parties for the same or similar products. The difficulty of establishing comparability of assets, products, and services creates an inherent problem for a methodology that bases affiliate prices on prices that independent suppliers charge to third parties. This is particularly the case when the product is programming. What may appear comparable from a production viewpoint, for example, may in no way be comparable from the perspective of the program viewer. Thus, a low-cost production that provides the producer with a high price on

the basis of high viewer demand may not be comparable to a similarly low-cost production with little viewer demand. (*Report and Order* at ¶268)

VI. Conclusion

Economic analysis makes it clear that the Commission's proposed change in the cable television affiliate transaction rule would be harmful to consumers. There is no demonstrated prospect that the change would yield significant benefits, because cable companies generally do not have the incentive and ability to use inflated affiliated programming prices to evade regulation. The rule would simply sacrifice the recognized benefits of vertical integration, and in particular reduce the quantity and quality of new programming services. The rule will also impose substantial compliance costs on cable systems, cable networks, and the Commission. Given these prospects, the proposed change should not be adopted.